EXAMINING THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

HEARING

BEFORE THE

SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

OF THE

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EXAMINING THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

THURSDAY, JULY 25, 2013

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS,
Washington, DC.

The Subcommittee met, pursuant to call, at 10:04 a.m., in Room 2360, Rayburn Office Building, Hon. David Schweikert [chairman of the Subcommittee], presiding.

Present: Representatives Schweikert, Chabot, Collins, Rice, Clarke, Velázquez, and Kuster.

Chairman SCHWEIKERT. Good morning. The hearing comes to order. This is actually one that I have been personally looking forward to today.

Today we take a look at a program that actually is fascinating. It started back in 1958, which was quite an education for me in how long. The founding principle of the Small Business Investment Company program that we are going to be speaking to today are based around something very simple: access to capital, and how do we help that.

In Fiscal Year 2012 alone, $1.92 billion in capital commitments were made to licensed SBICs with a $3.13 billion investment in 937 small business enterprises that were ultimately capitalized by the SBIC.

As the program grows in both size and dollars, it is necessary for us to guarantee that it continues to fulfill its mission.

For today's hearing, what I am going to ask each of you, we appreciate the written testimony. A couple of things: help educate us on what is working in the program, the reforms that have been made in the last couple of years, and also, systematically, we would love it if you have a moment within the time of your testimony, share with us what you see would make it work better because the ultimate goal here is capital formation and creation of jobs for our country.

Ranking Member?

Ms. CLARKE. Thank you very much, Mr. Chairman. Without being lambasted for stating the obvious, we all know that capital is the lifeblood for every small business. And without it, most firms simply would not survive.

In 1958, Congress recognized the need for long-term funding for growth-oriented small businesses and created the Small Business Investment Company, or SBIC Program. SBICs are privately

owned and managed investment funds, licensed by the SBA, that use their own capital plus SBA guaranteed funds to make investments in qualifying small businesses.

Since its inception, the SBIC Program has provided more than $64 billion of long-term debt equity capital to more than 165,000 small firms in Fiscal Year '12 alone. Investments from SBICs helped create or retain 69,000 jobs.

While we know it takes capital to run a business and continued investment to grow, the current economic environment presents significant obstacles to startup and early stage businesses seeking funding. Though there have been steady improvements and the Federal Reserve has reported that credit markets remain historically tight, unfortunately, as a result, many firms are unable to access traditional debt financing. For these reasons, the alternatives offered by the SBICs to small businesses, including simple equity as well as hybrid equity and debt financing, is critical, and will only play a more important role in job creation moving forward.

Although SBICs have helped bridge the gap between the need for capital demanded by entrepreneurs and the amount of funding available in the private market, there is room for improvement. SBA has estimated that the total unmet need for early stage equity financing for small businesses is approximately $60 billion each year. Specifically, investments in low income, underserved minority communities fall well short of the rest of the country. According to SBA data, the percentage of SBIC investments to women and minorities and veteran owned businesses, as well as LMI areas, declined 17 percent last year, and is on pace for another decline in 2013.

Clearly, changes at SBA, including new investment strategies, will be required to make a significant impact on the unmet capital needs of startups and businesses in traditionally underserved communities.

In the best of times, capital access can be something of an ordeal. Today that task has become especially challenging, and not just for businesses seeking traditional funding. During today's hearing, we will take the pulse of the SBIC Program, examine areas ripe for improvement, and hear from witnesses on the front lines helping today's main street businesses become tomorrow's Fortune 500 companies.

I would like to thank our witnesses and look forward to hearing their testimony on how to facilitate investment in our Nation's entrepreneurs and small businesses.

With that, Mr. Chairman, I thank you, and I yield back.

Chairman SCHWEIKERT. Thank you, Ms. Clarke.

As a reminder, we have 5 minutes. You will see the system of lights. As you get to the yellow light, it means there is 1 minute, and that just basically means talk faster.

Ms. Raghavan?

Ms. RAGHAVAN. Yes.

Chairman SCHWEIKERT. Did I get close? I have been practicing. Is the acting associate administrator for investment at the SBA. You have 5 minutes. Please share with us.

STATEMENTS OF PRAVINA RAGHAVAN, ACTING ASSOCIATE ADMINISTRATOR FOR INVESTMENT, UNITED STATES SMALL BUSINESS ADMINISTRATION, WASHINGTON, D.C.; STEVEN BROWN, PRESIDENT, TRINITY CAPITAL INVESTMENT, CHANDLER, ARIZONA; JOHN SHERMAN, FOUNDER, DIRECTOR, AND FORMER CEO, INERGY, LP, KANSAS CITY, MISSOURI; PHILIP ALEXANDER, CEO, BRANDMUSCLE, CLEVELAND, OHIO; AND DAVID T. ROBINSON, PH.D., PROFESSOR OF FINANCE, FUQUA SCHOOL OF BUSINESS, DUKE UNIVERSITY, CHAPEL HILL, NORTH CAROLINA

STATEMENT OF PRAVINA RAGHAVAN

Ms. RAGHAVAN. Chairman Schweikert, Ranking Member Clarke, and members of the Subcommittee, I am pleased to testify before you today to discuss the Small Business Investment Company Program. As many of you here today know, SBICs are part of a unique program at the SBA that puts long-term patient investment capital into America's small businesses, allowing them to grow and create jobs. Today, the SBIC Program serves as a model of a successful public-private partnership.

The program, which began in 1958, is market driven. We do not make the investment decisions. Experienced private fund managers do. The program oversees 295 operating funds with over $19.2 billion in private and SBA guaranteed capital and commitments.

SBICs invest in a wide variety of small businesses, such as R360 Environmental Services, which provides environmental solutions to the some of the world's leading oil and gas producers and providers. Although headquartered in Texas, the company has 26 facilities located across Louisiana, New Mexico, North Dakota, Oklahoma, Texas, and Wyoming, providing high-paying jobs to hundreds of new employees in rural areas.

Last year, the SBIC Debenture Program had its third consecutive record-breaking year in licensing and SBA commitments. In Fiscal Year 2012, SBA has licensed over 30 SBICs with almost $974 million in private capital, and approved over $1.9 billion in debenture commitments.

More importantly, debenture SBICs provide over $2.9 billion in financing to 795 small businesses across the country, more than twice the amount provided by debenture SBICs in Fiscal Year 2009. If you consider that SBICs issued only $1.4 billion in SBA guaranteed debentures, this means for every one dollar in debentures issued last year, small businesses received over two dollars in financing.

In Fiscal Year 2013, debenture SBICs are on track to exceed Fiscal Year 2012, having already provided $2.6 billion to 671 small businesses through June. SBA accomplished this while keeping the debenture program at a zero subsidy cost to the taxpayer.

Much of our credit for keeping the program at zero cost is our licensing process. A licensing process consists of three basic steps, which is initial review, capital raising, and final licensing. In determining whether to grant a license to an applicant, SBA considers the factors identified in our statutes and regulations, which include management qualifications, track record, investment strategy, and fund economics.

Even though a lot of work goes into evaluating the applicants, SBA has improved licensing processes and times over the past 4 years, reducing the average time from 15 months to less than 6 months. As a result, SBA expects to exceed last year's licensing numbers.

To help new licensees navigate our program, SBIC's Office of SBIC Operations initiated new webcasts on various aspects of the program. SBA also cut in half the average turnaround time on key decisions and operations from 60 days in Fiscal Year 2010 to 28 days in Fiscal Year 2012.

Obviously with rapid growth, SBA is concerned about program risk. Key to managing program risk is good reporting. SBA recently implemented a new web-based system to help improve communications and reporting. In addition, this Fiscal Year, SBA published its annual report in order to improve transparency and accountability.

With its processes and reporting in place, SBA believes it is poised to handle continued growth. We believe that a legislative change currently under consideration would allow this program to reach even more small businesses. The change would increase the SBIC Debenture Program authorization from $3 billion to $4 billion. While SBA has never hit the $3 billion annual authorization over a 3-year period, SBA more than doubled the debenture commitments approvals from $788 million in Fiscal Year 2009 to over $1.9 billion in Fiscal Year 2012. SBA expects to exceed the $2 billion this Fiscal Year. With continued growth, SBA will outpace its current authorization level.

We believe this modest change will allow the program to continue to grow, while keeping this program at a zero subsidy.

In closing, the SBIC Program is well positioned to finance small businesses across the country, and I look forward to working with you on the policies to help us achieve this goal.

Thank you, and I am more than happy to answer any questions you may have.

Chairman SCHWEIKERT. Thank you, Ms. Raghavan.

Our next witness is Steve Brown, who I am very pleased is from Arizona. Mr. Brown is the general partner of Trinity Capital Fund II, LP. Did we get that right? All right.

Mr. Brown, 5 minutes.

STATEMENT OF STEVEN BROWN

Mr. BROWN. Good morning, Chairman Schweikert, Ranking Member Clarke, and the other distinguished members of the Small Business Committee. I want to thank you for holding this oversight hearing today and examining the Small Business Investment Company Program. And I am here today on behalf of the Small Business Investor Alliance, which is a premiere organization of lower middle market private equity funds and investors.

As the chairman said, I am the managing member and the general partner of Trinity Capital Fund II. We are based in Phoenix, and we actually became licensed last year in September of 2012. And with our capital, currently the leverage that we have access to through the program, we are a little over $70 million in capital available for the market. So we are very excited about that.

Trinity focuses on equipment and fixed asset leasing and financing to both early stage and emerging growth small businesses, primarily backed by venture capital and/or other institutions. We often and sometimes do fund just privately-owned companies as well.

The industries that we fund most end up in the telecommunications arena, the manufacturing arena, and in technology. Our primary market focus is in the southwest and the west, but we will and have done deals throughout the United States.

I personally have been in the business of privately funding companies for over 20 years, and specifically in this particular debt market. I have been doing this for 10 years, and, again, was introduced to the program a few years ago. I am very excited to be a licensee in the program.

I have firsthand experience seeing these early stage and emerging growth companies struggle for capital. As the ranking member mentioned, it is a difficult market and has been for a number of years to find capital, and this program does meet that need. It is a long way between equity and solid debt financing that many of the banks offer, and this program fills that gap in many respects.

At Trinity, we have and are funding manufacturing companies in the technology space, the energy space, the recycling space, all things that are important to the government and to the economy. Companies that we have funded to date in our fund include a solar cell manufacture that has strong revenue, has survived the solar manufacturing difficulties in the market, and we are proud to be a part of that. We have provided equipment to help them grow. A manufacturer of LED lighting, which is a new and efficient way of lighting, and we have provided financing for manufacturing equipment there. We have also provided financing for a California-based manufacturer of chips for fiber optic in the telecommunications space.

We are currently working with a company in funding, literally as we speak in the next day or two, a tire recycler that has a great program of recycling tires and getting it back into that market and many other markets, including not just the tire industry, but plastics as well. So, we are excited about the portfolio of companies that we are funding.

I would like to just take a second on the SBIC Program. As mentioned, it started in 1958 and has done wonderful things, funding many, many companies along the way, including icons like Apple, and Intel, and others. It is important to note that most of my referrals in this business come from banks—banks that cannot or are unwilling to fund these companies, which, again, shows a reason for the need for the program.

Relative to the program, it is difficult to become a licensee, and that is good. We went through a very rigorous process to get licensed, and those that get licensed, I believe, having gone through the process, deserve to be able to manage this money. And I think that should continue.

There are some important things, as has been mentioned. Congressman Steve Chabot, I believe is the name, introduced and sponsored the SBIC Modernization Act, H.R. 1106, which will increase the family of funds from $225 to $350. We think that is im-

portant for this program. We believe leadership is important. There are some leadership positions that we need to be filled, and we think that is very important that that happens soon.

Technology is used in the marketplace and is available, and we think maybe some technology improvements could be made relative to us working, you know, with the Agency. And then the licensing process, it is a good and a stringent process. We think maybe some efficiencies can be handled there.

In closing, I just want to reiterate the success, the strength, and my support of this SBIC Program. The Agency is licensing qualified candidates through a stringent and thorough due diligence process, which creates a high standard for licensees to meet before becoming licensed, and having success.

On behalf of all SBICs, we applaud the efforts of the Agency and its employees, while encouraging continued improvements and efficiencies, as referenced herein, and in streamlining the process of licensing and communication with its candidates and licensees, and doing that without lowering the important high standard that has been set.

So, we are glad to be a licensee and really proud to be here today.

Chairman SCHWEIKERT. Thank you, Mr. Brown.

Our next witness is John Sherman, founding director and former CEO of, is it——

Mr. SHERMAN. Inergy.

Chairman SCHWEIKERT. Okay. So you are going around playing with us.

[Laughter.]

So, Inergy Limited Partnership, and was it out of Kansas City, Missouri?

Mr. SHERMAN. Yes.

Chairman SCHWEIKERT. You have 5 minutes, Mr. Sherman.

STATEMENT OF JOHN SHERMAN

Mr. SHERMAN. Thank you, Mr. Chairman. Thank you, Ranking Member Clarke and other members of the Subcommittee. My name is John Sherman, and I am from Kansas City, Missouri, near the congressional district of full Committee Chairman, Sam Graves. I appreciate the opportunity to be here today.

I am an entrepreneur who has been fortunate enough to launch and successfully grow and develop two companies from scratch. I am here today because I have been asked to share with you my experience with the SBIC Program while building Inergy. Today, the company is publicly traded on the New York Stock Exchange.

Three partners and I launched Inergy in 1998. We were seasoned professionals in the propane industry, and through our experience, we thought we could build a successful enterprise in the sector. The industry was fragmented with approximately 5,000 independent operators across the United States. We believed we could build a scalable enterprise.

Our strategy was simple: acquire local and regional propane operators with excellent customer service and safety records, grow the business rapidly both through acquisition, business improvement, and organic expansion, access the public capital markets to

ensure our ability to continue to grow, and ultimately diversify under the broader energy sector.

We funded the startup with $600,000 of our own money and raised $900,000 of equity from the seller of our original acquisition prospect. We went to several banks that turned us down for additional capital, but eventually obtained a $4 and a half million dollar acquisition loan. The bank loan was with a Kansas City bank. It had strict covenants and was personally guaranteed by us and our spouses. We were all in, so to speak.

With the goal of ultimately going public, we knew that we would need outside equity to serve as a bridge to an eventual IPO. We recognized in addition to raising capital, we needed the financial expertise that comes with institutional capital. We were business operators, not financial professionals, and we needed access to expertise to help us get to that next level.

We talked with a number of private equity and mezzanine financing firms. We ultimately connected with an SBIC, Kansas City Equity Partners, or KCEP, and on December 31st, 1999, we signed an agreement with KCEP for Inergy's first private investment. KCEP purchased a $2 million preferred interest in our fledgling company.

It is important to point out that they did their homework and took the time to get to know us. They recognized we had deep expertise in our industry. Our business plan was solid, and the founders were at risk. Plus, they were flexible as to the financial structure, and they were not asking for control, which was important to us.

We used that initial $2 million investment to acquire a number of small, independent propane operations over the ensuing months. We also benefited from the partnership with this SBIC, as they helped us to focus on what it would take to access public capital markets.

By early 2001, we identified a significant potential transaction, Hoosier Propane, located in Indiana that would provide the critical mass necessary to take Inergy public. We secured bank financing and obtained $7.4 million in equity from the sellers, and they also carried back a $5 million loan, but that left a $16 and a half million gap. I think, as Mr. Brown referred to, you know, that is the most challenging part of the financing. A group of private investors, led by Kansas City Equity Partners, purchased a $16 and a half million preferred interest in Inergy as the anchor investment. All members of the group were qualified as SBICs.

That $16 and a half million investment was the key piece of capital that allowed us to make this strategic acquisition. Very shortly after we closed that transaction, we filed the paperwork for our IPO process. Seven months later, in July 2001, Inergy went public. We grew the company dramatically after that, completing more than 75 retail propane acquisitions, becoming the third largest propane company in the country, employing nearly 3,000 people.

Over the years, we diversified into the midstream energy sector, and today the company is recognized as a major developer and operator of U.S. energy infrastructure, including storage, pipelines, and logistics assets.

In May, we announced a merger with Crestwood Midstream Partners, which would create a $7 and a half billion midstream energy company that is extremely well positioned to leverage the growing importance of the emerging shale plays around the country. The combined company will continue to create jobs and invest large amounts of capital in energy infrastructure across the United States.

We could not have done any of this, in my view, without the initial investment we received from these SBICs. We have raised literally billions of dollars of capital over the years, but nothing more critical as that early stage capital that the SBIC provided us. And that served as a platform for our long-term success.

Thank you, again, for the opportunity to be here today.

Chairman SCHWEIKERT. Thank you, Mr. Sherman.

Our next witness is Philip Alexander, president and CEO of Brandmuscle, and also speaking on behalf of the U.S. Chamber of Commerce.

Mr. Alexander, 5 minutes.

STATEMENT OF PHILIP ALEXANDER

Mr. ALEXANDER. Chairman Schweikert, Ranking Member Clarke, and distinguished members of the Subcommittee, thank you for inviting me to testify today on the SBA's SBIC Program that helps entrepreneurs and U.S. businesses to compete in the marketplace.

As the chairman said, I am Phil Alexander, CEO of Brandmuscle, a recently SBIC-funded small business with offices in Chicago, Cleveland, Austin, and Los Angeles. I am here to speak with you today not only as CEO of Brandmuscle, but also as a member of the U.S. Chamber of Commerce.

I came to the United States over 30 years ago to get an MBA from Case Western Reserve University. I pursued a career in marketing, and rapidly ascended to senior management positions both with national and international and local retailers, most recently as vice president of brand management at Pearl Vision, and prior to that, as Vice President of marketing for Western Auto, a subsidiary of Sears, Roebuck, and Company.

In 2000, I left the safety and security of the company, and Brandmuscle was born. The company sought a solution to a common problem that was seen in marketing, actually something that has similarities in politics. I think as former U.S. House Speaker Tip O'Neill said, "All politics are local." Well, we have the same issue in advertising. Our success is dependent on our understanding of what is needed, the issues of the local constituents and communities.

Brandmuscle was launched to provide just such a solution for Fortune 500 companies who needed to respond to marketplace conditions and provide tools and a suite of services so that the local distributors, and local franchises, local dealers, could develop programs that were appropriate at the local level. Today, Brandmuscle has 550 full-time, well-paid professionals in the United States.

Our early stage funding came from a variety of sources: initially, personal savings, and eventually an angel fund. Several successive infusions of venture capital allowed us to grow. We grew to about 150 employees, but reached a point at which even though we had

the growth opportunity, we could not add any more than three to four employees because of our debt equity structure. Clearly, we had to do something different.

Our initial investors needed to be taken out. The fund timing was over, but we needed cash to position us for expansion. We were too small to go public. Additional venture capital was too expensive. And unfortunately, since most of our assets were intangible property, typical debt financing was not available to us. Obviously, I think a challenge for us as a Nation as we move to more of a knowledge-based economy, companies like ours without intangible assets cannot find the financing.

The SBA's SBIC program was unique in its ability to provide Brandmuscle with the resources for our next phase. This Federal government program at zero cost to the taxpayer allowed an SBIC fund manager to leverage up to twice the amount of their private capital in order to provide a company like Brandmuscle with cost effective mezzanine debt financing.

In February of 2012, the Riverside Company, equipped with assets from their recently SBIC-backed fund, Riverside Micro-Cap Fund II, signed a purchase agreement to fully acquire Brandmuscle, utilizing a mezzanine restructuring debt agreement. The Riverside Company that you may familiar with was recently named M&A's private equity firm of the year with over $3.5 billion of assets under management, acquired over 300 companies, and have 200 employees worldwide. Brandmuscle had instant access to their managerial talent and the financial backing of a company like Riverside, thanks to the SBIC-backed fund.

Riverside's SBIC-backed fund had also allowed the company to acquire two other companies that we were quickly integrated with. One was Centiv Services, a Chicago-based portfolio marketing automation company, and TradeOne, an Austin-based Texas promotion company. As a result, we were able to strengthen our position in the market and acquire vertical integration. The company grew to 550 employees, and we not only grew the business and earnings. We also have added 42 employees in the last 12 months.

Chairman Schweikert and Ranking Member Clarke, without the SBA's SBIC Program, a company with the talent and resources of Riverside would not have looked at a company the size of Brandmuscle. I am convinced that it was the incentives that were afforded to Riverside by the SBIC Program which made us an attractive candidate for their consideration.

In conclusion, from the day that I conceived Brandmuscle to the present, obtaining sufficient capital has always been a challenge. I know firsthand that in order for a company to be successful and grow, it needs the right capital at the right time. At no expense to the taxpayer, the SBA's SBIC Program fills a void.

On behalf of the U.S. Chamber of Commerce Small Business Membership and myself, I strongly recommend that you retain, enhance, and strengthen this critical source of funding and capital for small businesses. To that end, I urge you to pass bill H.R. 1106, the Small Business Investment Company Modernization Act of 2013, into law.

I thank you for inviting me to testify, and I look forward to answering any questions.

Chairman SCHWEIKERT. Thank you, Mr. Alexander.

Ranking Member Clarke?

Ms. CLARKE. Thank you, Mr. Chairman. It is now my honor to introduce Dr. David Robinson. Dr. David Robinson is a professor of finance and the William and Sue Gross Distinguish Research Fellow at Duke University's Fuqua School of Business, and a research associate at the National Bureau of Economic Research.

He is one of the country's leading academic experts in the field of entrepreneurial finance, venture capital, and private equity. His work has appeared in the leading finance and academic journals and has been featured in the New York Times and the Wall Street Journal.

As the vice chair of the World Economic Forum's Global Agenda Council on Finance and Capital, Dr. Robinson is involved in international efforts to strengthen our understanding of the importance of financial markets for promoting entrepreneurship. He also advises a number of technology startups in the Research Triangle Park area.

He has earned his Ph.D. and MBA degrees at the University of Chicago, a master of science from the London School of Economics, and a bachelor of arts from the University of North Carolina at Chapel Hill.

Thank you for being here today, Professor Robinson, and we look forward to your testimony.

Chairman SCHWEIKERT. Professor Robinson, 5 minutes.

STATEMENT OF DAVID T. ROBINSON

Mr. ROBINSON. Ranking Member Clarke, thank you for that introduction. Chairman Schweikert, members of the Committee, thank you for inviting me to testify before you today.

Economic policy in the U.S. tends to focus on small business, but I think it is important to draw a distinction when we think about economic policy between supporting small business and supporting job creation. The best available economic data indicate that young businesses, not small ones, are the ones that are responsible for the lion's share of economic growth in our country, especially if we measure growth in terms of jobs.

The confusion is understandable because almost all young businesses are, by their very nature, small, but most small businesses are not young. Small businesses are, without question, an essential and important part of the fabric of American life, but most are not important engines of job creation. If they were, they would not continue to be small. They would grow and become large organizations.

Young businesses are a different story. Many fail, but the ones that succeed create jobs and, more generally, increase our country's economic dynamism. In this regard, the early stage SBIC initiatives are, in my view, laudable both in terms of their objective and in terms of their creativity. I think it is important that we think carefully about stimulating access to capital, not just for small firms, but for young firms.

I would like, however, to draw your attention to three facts about early stage business activity that I think, taken together, should temper our expectations of policies that attempt to stimulate early

stage business activity by extending leverage to equity investors in the market.

First, my work with Alicia Robb at the Kauffman Foundation shows that debt, not equity, is the primary source of capital for new businesses. We have long understood that debt is critical for small businesses. Small businesses rely very heavily on debt financing, but it is kind of a surprise that new businesses rely so extensively on the banking sector for access to startup capital. This is true across a wide range of startups. Even venture-backed startups rely very heavily on access to bank capital in their very earliest years of life.

As you have heard from Mr. Sherman's testimony, personal assets are critical in securing bank loans most of the time because home equity is such an important source of collateral for most individuals at the prime age for starting new businesses, which is typically in sort of the 35-year to 45-year range. What this means is that the collapse of the housing market, it was as much a crisis for entrepreneurship as it was a crisis for the banking system.

I think one of the things this tells us is that efforts to increase bank lending to this sector are incredibly important. And, you know, I think Administrator Raghavan's comments about the SBIC Debenture Program bear special consideration in light of the importance of that for startup activity.

The second fact is that early stage investing is extremely risky. For every Google out there, there are literally hundreds of ideas that never make it out of an inventor's garage. There is a very understandable need to curb behavior that would result in excessive risk taking and discourage bad investment activity in the early stage SBICs. But I think it is important to acknowledge that some of the CIP provisions and the payback rules that are in place are going to inhibit investment in some of the most desirable areas of the economy where we would like to see investment. Those are kind of the speculative investments that are often associated with some of the most disruptive technological innovations.

The third fact that I think we should bear in mind is that the gestation periods for early stage investments are prohibitively lengthy for many investors. It takes too long from the time of first investment to that IPO or M&A event for many early stage funds to earn a return. I think some of the most interesting features of the JOBS Act were those features that stimulated the development of the intermediate liquidity opportunities for early stage investors.

So I think these three facts together conspire to make your job a difficult one. We are simply swimming against the current when we try to stimulate early stage investment activity by leveraging existing equity. And so, in light of that, what will be the underlying economic mechanism that will be responsible for success when we see it? In my view, it is this: early stage investors without sufficiently deep pockets are often discouraged from making speculative early stage investments because they are worried that their early investments will become diluted by later stage equity. It is not that they need more capital now. They need more capital to be available later so that they can make the follow-on investments.

In my view, the success of this program will hinge on providing that capital to those early stage investors. Thank you.

Chairman SCHWEIKERT. Thank you, Professor.

As you heard the bell, we have a vote series that is about to be called. But we still have a few minutes or so. I thought we would move to the lightning round of questions.

[Laughter.]

And, Mr. Rice?

Mr. RICE. I can go 5 minutes.

Chairman SCHWEIKERT. No, no, no, no, we will shoot for the one. Lightning round. Mr. Rice?

Mr. RICE. Professor, I am a tax lawyer and CPA by trade, and I have certainly seen the troubles that small businesses have with access to capital, and totally agree with you their primary source is the banks, and particularly small banks.

Now, you know, coming out of the financial crisis, we had a flurry of laws designed to prevent banks from taking too much risk, but on the other hand, you have this conundrum that you are saying we need them to take risk if we are going to create these jobs and create this small business economy. So, we created a plethora of laws to avoid this risk, like Dodd-Frank, for example.

In your opinion, does that stifle this small business job creation? Does that stifle this risk taking? I hear from my small bank friends and former clients that it is a real problem. Tell me your opinion.

Mr. ROBINSON. Sir, thank you for the question. You know, in some ways you have expressed the dilemma perfectly. We want to put in responsible curbs against bad behavior, but at the same time, by curtailing risk taking, we are starving capital, preventing it from flowing to the very areas of the economy where we need it most. So I think there is no question that removing the regulations or lessening regulations around bank lending would help small business activity.

Perhaps to say it a little more differently, I think that we need to move away from sort of a one-size-fits-all approach towards banking regulation to something that allows smaller banks that serve the small business sector more maneuverability than is currently afforded.

Chairman SCHWEIKERT. Mr. Collins?

Mr. COLLINS. Oh, thank you.

Chairman SCHWEIKERT. Do you want to take the——

Mr. COLLINS. Sure.

Chairman SCHWEIKERT. Actually, can I do this, just because we are doing the lightning round? Ms. Clarke?

Ms. CLARKE. Mr. Chairman, I would like to yield to the ranking member of the Committee, Ms. Velázquez of New York.

Ms. VELÁZQUEZ. Thank you, Ms. Clarke, and thank you, Mr. Chairman, for this important hearing.

Let me just say, Professor Robinson, I do not know how many times we hear about how Dodd-Frank is hindering the flow of capital to small businesses. But the fact of the matter is that the distinction is made by Dodd-Frank in the sense that the one-size-fits-all approach does not work. And, indeed, that is what Dodd-Frank does in the sense that if I ask any business who is lending to them, community banks, are not the big banks, are the community banks, are the independent banks.

Dodd-Frank exempted the community banks from those regulations. They do not have assets of more than $10 billion. So, I just want for the record to reflect that. I am a member of the Financial Services Committee, as well as some of the members here, and they know that.

I would like to ask the acting associate, Ms. Raghavan, and welcome to the capitol. You did a very good job in New York, and I hope that you continue to do a better job here. But I want to help you. I want for you to succeed. And this is a very important program as a tool of promoting economic development.

And my questions are based in the new reality that the small business face is changing in America. It is more women. It is more blacks. It is more Latinos. And we need to make sure that the programs that are in place will benefit everyone.

So, only 20 percent of businesses receiving financing in the SBIC Program are located, only 20 percent in LMI areas. This suggests that we need more SBICs licensed to make investment in these areas. Even though the statute in Section 301(c)(3) of the Small Business Investment Act provides general guidance on that appropriate experience, the SBA has established rigid rules. While we want high standards, the SBA should be considering other types of experiences that clearly demonstrate qualifications for the SBIC Program.

Will the SBA consider these alternative types of experiences in evaluating SBIC applications, especially to target more minority licensees and low income areas?

Ms. RAGHAVAN. Thank you for the question. We do agree that LMI areas, especially women and minorities, are very important to the program. In fact, with our new licensees of applicants of funds, we have had more women and more minority funds join. And we continue to actually press out and do a bigger marketing campaign, including using our district offices in the actual country to work with the fund managers to get to through the program.

We are actually putting through clearance on our new licensing SOP, which is looking at the alternative ways of licensing applicants. And one of the things we are taking into consideration is different types of track records to ensure that we do have more investment funds that are looking into those hard impact areas.

We so far have the impact funds. We have two of them. One is in Michigan looking at that economic development there, and we look to encourage more of those funds, including States as well as mayors' offices, to join the pension funds to be able to encourage more growth in LMI areas.

Ms. VELÁZQUEZ. Okay. Thank you very much, and I will be working on reaching out to you so that we make sure that changes are made.

Mr. Chairman, I would like to ask unanimous consent to submit for the record the testimony of Jose Fernandez. He is the chairman and CEO of Omega Overseas Investment Corporation.

Chairman SCHWEIKERT. You have unanimous consent.

[The information follows:]

Ms. VELÁZQUEZ. Thank you, and I yield back.

Chairman SCHWEIKERT. Thank you, Ms. Velázquez.

As we are running, Mr. Collins had a question.

Mr. COLLINS. Yeah. Thank you, Mr. Chairman. I would be quick, but, Mr. Brown, I am especially interested in the dynamic. As Mr. Alexander said earlier, the cost of venture capital was just too much. We all know the Golden Rule, "He who has the gold makes the rule." And I am assuming, Mr. Alexander, you are talking about dilution. They would come in and say, sure, we will lend you some money; we are taking 80 percent of your company, and for an entrepreneur who has put their heart and soul in it.

Now, Mr. Brown, I guess my question is, being an SBIC and having government funding multiply your private investment, would you say that that allows you to be a little fairer, if you will, with companies like Mr. Alexander's so the dilution would otherwise be much worse for the investor if you did not have the leverage of the SBIC?

Mr. BROWN. The answer to that question is yes, and that is one of the benefits of the program. You know, dilution is a big issue for small businesses, for growing businesses. Equity is critical to get that done. We see that over and over again. And whether it is venture capital, private equity, or even private groups that come together to provide equity can be very dilutive to the founders, the people who are the heart and soul of the company that put it together.

So, this program affords the opportunity to come in and provide debt with an equity kicker occasionally in the form of a warrant that provides much less dilution than might otherwise be had with equity. And so, it really is one of the unique and beneficial parts of the program that can save dilution for ownership and still, you know, provide some upside for licensees making——

Mr. COLLINS. Yeah. One quick follow up. Does that also help you get private investors, the investors that come into your fund and you say we are going to be an SBIC, and I am going to leverage your money two to one, three to one. Therefore, we can be more fair, if you will, with the company.

Mr. BROWN. It does. It provides the opportunity for investors to receive a good return on their investment. And because of the leverage and the access to the capital at the cost that we have access to, it allows us to be competitive in the marketplace, and provide competitive offerings to those that really need it as opposed to some of the dilutive options.

Mr. COLLINS. Thank you, Mr. Chairman. Thank you.

Chairman SCHWEIKERT. Okay. Thank you, Mr. Collins.

Mr. Chabot, it is nice having you here. I am not going to ask, but we were talking about your legislation a moment ago.

Mr. CHABOT. Thank you. I just want to put in a plug for it. Thank you, Mr. Chairman.

Chairman SCHWEIKERT. And for our witnesses, how is your timing? We have a vote series. I think it is going to be about 50 minutes is my best estimate. In your lives, are you able to come back?

Mr. ROBINSON. Yes.

Mr. ALEXANDER. Yes.

Mr. SHERMAN. Yes.

Mr. BROWN. Yes.

Ms. RAGHAVAN. Yes.

Chairman SCHWEIKERT. All right. With that, then we are going to have votes on the floor of the House, so we are going to adjourn for about 50 minutes. And we will reconvene at the end of votes for another series of questions.

And with that, we are at recess.

[Recess.]

Chairman SCHWEIKERT. Reconstitute the Subcommittee. Are we back on the record?

Ranking Member, do you mind if I jump in with a couple of questions?

Ms. CLARKE. Please go ahead.

Chairman SCHWEIKERT. Mr. Brown, you and I had a conversation yesterday, and I want to better understand because I partially also want to put this on the record not only from your testimony, but from our conversation. The mechanics you went through to basically be certified to be one of the funds that actually can put the money into Mr. Alexander's, you know, type of businesses, and where you thought it worked, and where you thought there might be some bottlenecks.

It is okay. We were not talking about you behind your back, I promise. And where you thought that whether electronic pothole or maybe certain levels of review may be overkill. Mr. Brown?

Mr. BROWN. Yeah. So, our experience, you know, we are encouraged to and sought out a law firm. We actually used the firm of McGuireWoods in Chicago, and I found out that there are few that specialize in this. And we submitted a, you know, brief summary that was reviewed by the SBIC and had discussions with an analyst, and was essentially, as I recall, invited to move forward in what is called the MAQ process. It is a management assessment questionnaire. And we did that.

We submitted our MAQ. It is a management assessment questionnaire. It is a very thorough questionnaire about who we are, our background, our track record, et cetera, for the team. And we went into what is called a MAQ phase or the pre-licensing phase, I think it is called.

Very good process. The analytical support or connection that we had there at the SBIC was good. Very smart folks that we dealt with. Really took time to understand our business, which was great.

Chairman SCHWEIKERT. But my great hope is more just the steps you had to go through——

Mr. BROWN. Okay.

Chairman SCHWEIKERT.—the costs you had. I am hunting for if there is anything, if I can turn to the acting administrator and say, hey, have you thought of this pothole? How do we make it faster, save money, and still have the same type of core costs?

Mr. BROWN. Okay. So, I will consolidate. Thanks.

MAQ phase, we went to a meeting with the committee, and we got what is called a green light letter, which kind of got us through the MAQ phase, and then the opportunity then to formally apply for the license. And then, we went through a licensing phase where there was some of the same work that was done. There was also some additional work, but there was some of the same work that was done there.

Chairman SCHWEIKERT. And share with me the timeline.

Mr. BROWN. So, we had a little different story, and let me just say that. We actually went from start to finish, from our application through, I am going to call it our first go round, was about 12 to 15 months. We actually had a change of personnel. We had to go back in, and we ended up with about 2 years in the program.

But had we not made the change of personnel, it would have been about a 12- to 15-month process, which we were anticipating going in. So, there was the MAQ phase, then there was the licensing phase, and then, as I recall, there was a second committee that we went and visited with at the licensing phase, and we were approved at that. And then, there was an additional committee that we did not need that ultimately voted. So, I believe that was basically the process.

Timeline, as I shared, you know, sort of had it gone exactly the way we intended, it would have been about 12 to 15 months. And then, the cost was, you know, for us was in the $200,000 to $250,000 range, and that is everything all in, legal, you know, just doing everything that we had to do to get to the finish line.

Chairman SCHWEIKERT. Okay, Administrator Raghavan. I am going to get it just right. And I know for fairness, you have only been there how long?

Ms. RAGHAVAN. This is my third week.

Chairman SCHWEIKERT. Okay. So, that final review, so it is sort of like a third committee at the very end that is here, we will say, at the Federal level?

Ms. RAGHAVAN. Yes.

Chairman SCHWEIKERT. What can you tell me about that, and what can you tell me about what value you think that ultimately adds, because the hopeful participant does not actually really appear in front of that committee.

Ms. RAGHAVAN. Correct.

Chairman SCHWEIKERT. So what does that one accomplish?

Ms. RAGHAVAN. Sure. So technically, it is the Agency committee, which is the committee he is talking about, the third committee, which has a group of all senior officials in the SBA: our associate administrator of CAP access, our associate administrator of investment, as well as our CFO. It is the actual committee that actually issues the license.

The first two, the investment and the division committee, are actually committees that make recommendations, so they are working with the applicants. That is why we do the interviews to go through the process. And then, it is the agency committee that makes the final decision because the administrator signs off on the license.

It is similar to what is in the private sector. They have several reviews of different portfolios that come in when they do funds to funds. So we mimic that process on purpose so that it is very similar. That committee works very well. They all have financial backgrounds, and they understand what we are looking for, and they have been looking at these. They get the entire briefing book that these gentlemen have put together, which includes their background history, their management fund, the organization structure, and where they plan to get the funds.

Chairman SCHWEIKERT. Thank you.

Ms. Clarke?

Ms. CLARKE. On the issue of the licensing, I wanted to circle back to, I think it was the ranking member, Ms. Velázquez, had talked a little bit about the licensing of the SBIC Impact Investment Programs in economically distressed communities. And I think you mentioned there are two licensees that have been approved specifically for the program.

And my question is, why have more impact investment SBICs not been licensed by the SBA? The process, is it not having enough capital to really meet the criteria? What is it that you are finding?

Ms. RAGHAVAN. So the Impact Investment Fund is actually new. It is only in its second year, so that is one of the reasons, I think, everything that is new people do not understand, which is why we have an aggressive marketing plan to work with actually States and local governments to get the word out because it is really looking at the areas across the country.

We have two that have gone through the program. We actually have six funds all together in our traditional SBIC Program that do impact investing. So all together, we have eight in the program.

One of the reasons I think the Impact Investment Program is a different hurdle is the percentage that we ask. We are asking at least 50 percent to be in low/moderate income areas on the impact investing versus the normal SBIC fund. They can do 10, 15 as they wish.

But I think as we go around marketing and explaining the program, we should be getting more, which is the reason why we revamped even the limit to go up to $250 million as opposed to the $180 when it was started.

Ms. CLARKE. And is it that there is a certain assumption around the amount of risks that are involved with making investments in those impact areas that people do not want to take on, or have you gotten any feedback? Other than the fact that it is a new program, is there anything that you anticipate that makes people hesitant or companies hesitant to engage this particular——

Ms. RAGHAVAN. I think it is a new area for companies to go ahead and actually invest in. And so, we are trying to broaden to show them that they will get the same returns or similar returns that they get in other programs. And that is part of the education process that we at the SBA are doing.

And I think the Michigan Fund is a perfect, sterling example of looking a big time pension fund to invest in impact areas, and we have a second fund in California doing the same. And as they get more press and people understand more about it, I think we can get some more funds in there. I think it is more about knowing that the risk involved is similar to any other type of risk that is taken in the market.

Ms. CLARKE. Very well. And, Mr. Brown, I just wanted to do a follow up because in your opening statement, you spoke to the virtues of the SBIC Program that you have embraced. But you also mentioned about licensing efficiencies was sort of like—I had a question about, you know, whether it is a lacking of efficiency. And I think you talked a little bit about the process and some redun-

dancy and paperwork, or administrative activities. But was there something specific in the licensing that you found to be inefficient?

Mr. BROWN. I would maybe point to—sorry. Thank you. I would maybe point to sort of the technology or lack thereof. And, in fact, the program is now bringing online some of our opportunities to transfer documents, to file forms—468, I believe—and others. So, there is progress being made. But what we do not often do when we are transacting business is send lots of sort of hard paper files. And so, that happened during this process.

So, I think the use of existing technologies in the marketplace, which I know the Agency is working on, will make the process more efficient. That would be a prime example of what I was talking about.

Ms. CLARKE. Okay, very well. Do you anticipate a full-throated technological revolution with this process? Are we on our way?

Ms. RAGHAVAN. Well, as you know, we have been under sequestration and also continuing resolutions, which has made it a bit difficult to invest in technology. So, even though under those circumstances we were able to make our 468, which is an application online, and we just launched the web system, we are trying. In fact, one of our initiatives is to make sure it could go paperless. We are doing that in several initiatives across the Agency. But for the SBICs, it is very important. Naturally they work in an e-environment, and we are trying to make sure that we can also do that.

But we put in plans for more budget for technology, so as the technology can be upgraded, we can serve their needs better.

Ms. CLARKE. And you fed right into my next question, and that was, how has sequestration affected the SBA's ability to provide effective oversight over your portfolio?

Ms. RAGHAVAN. It has definitely affected the travel cap. We have to do examinations of all the SBICs, so with the current travel cap, we were unable to do as many as we would like, just because we do not have the dollars to go. As well as we would like to do some more outreach and marketing, and part of that is going to conferences and making sure people understand the Impact Investing Fund, and working with the fund managers, and understanding our program. So, the travel has been very difficult. And obviously on the technology front, we have not been able to invest as much as we would like to to ensure

On the program operations side, it has not been affected. We still continue to make sure our licensing times are down. We still continue to work with them remotely. But those are the effects we have had.

Chairman SCHWEIKERT. And once again, I want to apologize to all of you for the nature of the chaos of today. It is just sort of the way this day will work.

Is there anything you think that would be important for us to hear to put onto the record that we have not asked, that we have not pursued here? And it is always dangerous when you ask an open-ended question that you actually do not know the answer.

In that case, I am going to move to a closing here. I am going to, and I did not see it in the normal script here. But is this a one-month Committee or one-week Committee being submitted to the record?

Voice. Five legislative days.

Chairman SCHWEIKERT. Okay. You each are going to have 5 legislative days if you have other documents you would like to submit. You may also receive questions from those of us here.

And actually, my ranking member does have another question. Ms. Clarke?

Ms. CLARKE. Thank you, Mr. Chairman. Thank you for the indulgence.

Dr. Robinson, I had one final question for you, and that is, finding the right balance for government-backed investment programs can be challenging. If it permits too much risk, taxpayers can end up on the hook. If it does not take enough, the program will not spur economic activity in the areas unable to secure financing.

What is your view on the current risk appetite for the SBIC Program, and is it too much, or too little, or just right?

Mr. ROBINSON. Thank you for the question, Ms. Clarke. I think it is a delicate balance that we have to strike, and I understand both sides of the equation, both the need to make sure that we curb excessive risk taking and bad behavior, but also the very great need to spur risky investment.

I think that we have to be very clear about what we want the objectives of the program to be and what we are trying to accomplish. I think if what we wish to do is promote innovation, you know, truly promote risk taking investment, then I think we probably need to scale back some of the oversight—well, I should not say "oversight"—scale back some of the restrictions on investment.

I think that if the objective is to, you know, provide more capital to the small business economy, then you probably have the balance about right. But, you know, the way I would look at it is, again, I would go back to what I said in my opening testimony. I think we need to draw a distinction between the small business economy and the entrepreneurial economy. And I think that if the objective of the program is spur entrepreneurship, then we need to do, in my view, dial the meter more towards risk taking.

Chairman SCHWEIKERT. Thank you, Ms. Clarke.

And a couple of other quick things here. Professor, I am going to actually hunt for some writings you have done, and if you can send me some. You actually said something that, in reflection, is brilliant: the difference between the small business and the growing, you know, the very young growth business, and how, you know, we often say "small business," but these are very different than, like, our family business that may have been around 40 years that has just stayed some of the size. So, I would like to understand more about that because that may have a different risk appetite in what we have to do.

Obviously, as members of Congress, there is this constant fear of do we wake up tomorrow and have a black swan type of event, something that was out in the tail. And we wake up the next day and we are Fannie or Freddie, or something of that nature. At the same time, if you have managed your exposure to certain consequences out there, have you, you know, done it in a robust enough fashion where we are actually meeting our mission.

And with that, I ask for unanimous consent that members have 5 legislative days to submit statements and supporting materials

for the record. And without objection—I always wait for someone to give me an objection one day—so ordered.

Chairman SCHWEIKERT. And with that, the hearing now is adjourned.

[Whereupon, at 12:02 p.m., the Subcommittee was adjourned.]

APPENDIX

U.S. SMALL BUSINESS ADMINISTRATION

WASHINGTON, D.C. 20416

TESTIMONY OF

PRAVINA RAGHAVAN

ACTING ASSOCIATE ADMINISTRATOR FOR INVESTMENT AND INNOVATION

U.S. SMALL BUSINESS ADMINISTRATION

BEFORE THE U.S. HOUSE SMALL BUSINESS SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

JULY 25, 2013

Chairman Schweikert, Ranking Member Clarke and members of the Subcommittee. I'm pleased to testify before you today to discuss the Small Business Investment Company (SBIC) program. I want to thank you for calling this hearing, and for your strong support of the Small Business Administration (SBA) and your commitment to providing growth capital to small businesses.

As many here today know, the SBICs are part of a unique program at SBA that puts long-term patient investment capital into America's small businesses, allowing them to grow and create jobs. Today, the SBIC program serves as a model of a successful public-private partnership. The program, which began in 1958, is market-driven. We don't make the investment decisions; experienced private fund managers do.

The program oversees 295 operating funds with over $19.2 billion in private and SBA guaranteed capital and commitments. These SBICs invest in a wide variety of small businesses, such as JSI Store Fixtures in Milo, Maine, which manufactures specialty fixtures and displays for the supermarket industry. The company more than doubled its workforce from 80 to 200 employees after receiving an SBIC investment in 2006. The company won an award last year from the Small Business Investor Alliance at the SBIC portfolio company of the year. Another great example is R360 Environmental Services which provides environmental solutions to some of the world's leading oil and gas producers to ensure environmental performance and compliance. Though headquartered in Houston, Texas, the company has 26 facilities located across Louisiana, New Mexico, North Dakota, Oklahoma, Texas, and Wyoming, providing high paying jobs to hundreds of new employees in

rural areas. While the company has recently been acquired, R360 increased jobs by 40% after its SBIC investment.

I am proud to tell you that last fiscal year (FY) the SBIC Debenture program had its third consecutive record-breaking year in terms of the number of SBICs licensed, new private capital, and SBA-guaranteed leverage commitments. In FY 2012, SBA licensed 30 SBICs with $973.9 million in private capital and approved over $1.9 billion in Debenture commitments.

More importantly, in FY 2012 Debenture SBICs provided over $2.9 billion in financings to 795 small businesses located across the country, more than twice the amount provided by Debenture SBICs in FY 2009. If you consider that SBICs issued only $1.4 billion in SBA-guaranteed Debentures to support these financings, this means that for every $1 in Debentures issued last year, small businesses received at least $2 in financing. Over the past 5 years, SBIC debenture investment dollars were dispersed across a broad spectrum of industries, including 18% going to small U.S. manufacturing firms. In FY 2013, Debenture SBICs are on track to exceed FY 2012 financing dollars, having already provided almost $2.6 billion in financing to 671 small businesses through June 2013. SBA accomplished this while keeping the Debenture program at *zero subsidy costs* to the taxpayer.

Much of the credit for keeping the program at zero subsidy cost is our licensing process. The licensing process consists of 3 basic steps: (1) Initial Review by SBA; (2) Capital Raising; and (3) Final Licensing. In the first step, SBA reviews the applicant's track record and performs initial due diligence, leading to a decision by SBA's Investment Committee as to whether to give the applicant a "green light letter". Once an applicant receives a green light letter, the managers have up to 18 months to raise the minimum private capital and submit a license application. After receiving the application, SBA reviews all legal documents and updated track records and performs further analysis and due diligence before consideration by the Investment Division Licensing Committee and then the Agency Licensing Committee, which is composed of the AA for Investment and senior SBA officials. SBA's Administrator then approves and issues the SBIC license. In determining whether to grant a license to an applicant, SBA considers the factors identified in its regulations (13 CFR § 107.305), which include among other things: management qualifications; track record; proposed investment strategy; and fund economics. As a result of this process, only 1 of the 157 Debenture SBICs licensed since 2002 has been transferred to the Office of Liquidation to date.

Even though a lot of work goes into evaluating applicants, SBA improved licensing times over the past four years. It used to take almost 15 months on average to get a new SBIC fund licensed. That average is now less than 6 months. As a result, SBA is on track to exceed its FY 2012 licensing numbers, having already licensed 26 SBICs with almost $1 billion in private capital and approved over $1.5 billion in Debenture commitments in FY 2013 to date.

To help this large group of new licensees navigate our program, SBA's Office of SBIC Operations has initiated webcasts on various aspects of the program. SBA also has reduced average turnaround times on key decisions in Operations by over 50%, from 60 days in FY 2010 to 28 days in FY 2012. This improvement helps SBICs get critical financings to small businesses in a timely manner.

Obviously with rapid growth, SBA is concerned about program risk. Key to managing program risk is good reporting. SBA implemented a new web-based reporting system in FY 2013 to help improve communications and reporting from program participants. In addition, in the first quarter of this fiscal year SBA published its most recent annual report in order to improve transparency of the program and provide accountability.

With its processes and reporting in place, SBA believes it is poised to handle continued growth. And we believe that one legislative change currently under consideration would allow this program to reach even more high growth small businesses. Specifically, the proposal would increase the SBIC Debenture program authorization from $3 billion to $4 billion. While SBA has never hit the $3 billion annual authorization limit, we have grown the program significantly in recent years. Over a 3 year period, SBA more than doubled the amount of Debenture commitments approved, from $788 million in FY 2009 to over $1.9 billion in FY 2012. SBA expects to exceed $2 billion in FY 2013. With continued growth, SBA will outpace its current authorization level.

We believe this modest change will allow the program to continue to grow without any significant additional risk to the taxpayer, allowing us to keep this program at zero subsidy.

In closing, the SBIC program is well positioned to finance small businesses across the country. I look forward to working with you on policies that will help us achieve this goal. Thank you and I am happy to answer any questions you may have.

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

Hearing on "Examining the Small Business Investment Company Program"

House Small Business Committee

Subcommittee on Investigations, Oversight and Regulations

July 25, 2013

Testimony by Steven Brown, Trinity Capital Fund II, LP, Phoenix, Arizona

On behalf of the Small Business Investor Alliance

www.SBIA.org

1100 H Street, NW Suite 610 Washington, DC 20005 (202) 628-5055 **sbia.org**

Good morning Chairman Schweikert, Ranking Member Clarke, and Members of the House Small Business Subcommittee on Investigations, Oversight, and Regulations.

Thank you for holding this oversight hearing today to examine the Small Business Investment Company (SBIC) program. I am here today on behalf of the Small Business Investor Alliance, the premier organization of lower middle market private equity funds and investors.

My name is Steven Brown and I am the Managing Member of the General Partner of Trinity Capital Fund II, LP, based out of Phoenix, Arizona. Trinity Capital became a licensed SBIC in September of 2012, with a current investment capacity of $76 million, assuming two tier SBA leverage. Trinity focuses on equipment and fixed asset leasing and financing to both earlier staged and emerging growth small businesses primarily backed by Venture Capital and/or other institutional investment. The industries we fund most are telecommunications, manufacturing and technology, with our primary market focused in the southwest and west, however we will fund deals in other US markets.

Since our fund was only recently licensed, I can only speak to our direct experiences during the relatively brief period we have been in the program. However, because this hearing is performing oversight of the entire SBIC program, I am attaching a letter from our trade association that highlights the broader perspective they have seen across the industry over a longer period of time.

Background

What was true in 1958 is still true today. It is very inefficient and difficult for large financial institutions to provide capital to small businesses, even if the small business is profitable and trying to grow. To address this reality Congress and the Eisenhower Administration applied market principals as they created the SBIC credit facility that uses leverage to augment private investment in the small business market. Because of the way the program is structured, this leverage must be provided with a zero subsidy rate—meaning no cost to the taxpayer. The SBIC debenture program continues to successfully operate at its statutorily required zero subsidy rate. The SBIC debenture program has consistently run at a surplus of several hundred million dollars and the President's budget estimates that this surplus will grow next year. Since the creation of the SBIC program, SBICs have invested more than $58 billion in over 100,000 domestic small businesses. Some of these small businesses have since grown into icons of American free enterprise including: Apple, Intel, Outback Steakhouse, Callaway Golf, and many others. There are also thousands of other fantastic SBIC-backed businesses that are lesser known, but that are mainstays of local economies.

SBICs are highly regulated private equity funds that invest exclusively in domestic small businesses. Debenture SBICs raise private capital, pass a rigorous licensing process, and then are able to increase the amount of capital available for investment by accessing leverage through an SBA-backed credit facility. These

funds then invest in a portfolio of U.S. small businesses, creating jobs, fostering innovation, and fueling economic growth.

The SBIC debenture program fills a critical need by providing growth and transition capital to small businesses. During the financial crisis SBICs scaled up to provide critical capital that saved many businesses and many jobs. The SBIC debenture program continued to operate at a zero subsidy rate throughout the financial crisis. Private capital of operating SBICs doubled over the past four years, growing from $3.4 billion at the end of fiscal year 2009 to $6.8 billion today. This growth came at no additional cost to the taxpayer, a remarkable feat for a public-private partnership. This program is good public policy because it fills a critical market need that otherwise would largely go unmet while simultaneously providing real taxpayer protections. This is a rare alignment of market forces with thoughtful public policy.

Trinity Capital is an example of how an SBIC Fund can provide critical capital to businesses that will now continue to grow long after the SBIC has exited the investment. Trinity Capital to date has funded equipment purchases for the growth of a manufacturing line with Suniva, a manufacturer of solar cells based in Atlanta, Georgia. Suniva has experienced strong revenue, has survived the solar manufacturing down market and is a strong US based manufacturer supplying the residential supply market. Our capital has helped grow capacity at the Suniva plant. We have also funded manufacturing equipment for Soraa, a US based manufacturer of LED lighting, an emerging technology that is replacing much of the existing lighting in the marketplace with more efficient and cost effective energy lighting. Soraa is experiencing growing revenues and has state of the art technology in this space. We have also funded Clariphy, a California based manufacturer of chips for fiber optic communications. Clariphy's product produces a much more efficient use of fiber optic networks resulting in more bandwidth and speed. Trinity financed test equipment for Clariphy, a company who is experiencing strong and growing revenue. We are currently funding a tire recycling company that takes tire manufacturing waste and grinds it into a product that is used for production back into the tire industry. Trinity is currently funding and plans to fund innovative US based companies that are providing both technology and know how to make existing processes more efficient and more profitable. Additionally we have already demonstrated a desire and ability to work with companies that are coming up with better and more efficient energy solutions and alternatives.

Let me start out by highlighting how Congress can act right away to increase capital flowing to small businesses. Congressman Steve Chabot (OH-1) introduced the SBIC Modernization Act (H.R. 1106) earlier this year which increases a critical cap on the amount that successful SBICs can access through the SBA credit facility.

In fact, thanks to the bipartisan work by this committee at the end of last year, the same legislation passed through the House of Representatives on December 17, 2012, with a very strong bipartisan vote of 359–36; however given the time constraints at the end of the year, the Senate did not act on the bill. Congressman Chabot

reintroduced the bill this year with bipartisan support from nine of his colleagues. It is worth noting that a Senate version of the bill, backed by Senators Landrieu (D-LA) and Risch (R-ID), passed out of the Senate Committee with broad bipartisan support.

It is important to note that H.R. 1106 does not increase federal spending or require new appropriations. H.R. 1106 adjusts the maximum amount of leverage available to multiple SBICs to a limit of $350 million. The only funds that can access the higher limits are funds that have successfully operated an SBIC and have gone through the licensing process at least twice. Increasing this limit will keep proven small business investors in the program and increase the amount of capital flowing to small businesses. It is a logical to keep the best small business investors investing domestically. This increase has bipartisan, bicameral, and Administration support. We encourage its passage.

Now let me turn the focus of my testimony to discuss issues that should be relevant as part of an oversight hearing. It is important to put on the record the very significant improvements to the SBIC program that have been implemented over the past several years. Licensing times have been reduced from a waiting period of nearly two years to about six months. The number of licenses issued per year has increased from fewer than 10 per year to 30 per year. This increase in licensing was achieved while maintaining, if not raising, the standards for licensure. Thanks to legislative improvements, the number of regulatory hurdles to normal fund operations has been reduced and has allowed SBA resources to be better allocated to address more pressing needs. These improvements are important and should not be overlooked.

These reforms attracted more private sector investment and allowed SBICs to operate closer to the speed of business to back thousands of successful entrepreneurs. Despite the many improvements, there are still areas that require meaningful changes to maximize the program's ability to get capital in the hands of small businesses.

SBA Leadership

The biggest short term challenge that must be addressed is the departure of many key personnel at the SBA. The SBIC program has benefitted greatly by the quality of the people appointed to lead the SBA and the attention they paid to the SBIC program. SBA Administrator Karen Mills is expected to leave her post by the end of August and there is no word yet on who her replacement will be. There are also vacancies for the positions of the Deputy Administrator, the Associate Administrator for SBA's Office of Investment, which administers the SBIC program. These are all important positions at SBA that should be filled as soon as possible. The Senate confirmation process takes a long time, and without any new appointments by the President, this process will be ongoing through the fall. We do not want to see programs in charge of regulating and overseeing billions of dollars lacking strong leadership. There are significant questions about how licensing and certain operational decisions will be made when there is no Administrator.

It is not clear who will be acting as Administrator when this position is vacated in August.

Technology

There are a number of major technological and information systems challenges that make it very difficult for SBA staff to administer the SBIC program effectively. We encourage a meaningful review and improvement in both the technological tools and the policies around them.

One of the major problems for SBIC funds is the ability of the SBA to accept documents electronically. The SBA still requires SBICs to send hard copies for most documentation requests. The email system at SBA is unable to send or receive many documents. It is common that critical documents are delayed or lost in the mail room. The SBA needs to be able to communicate electronically. Further, it has been over a decade since laws were changed to require the acceptance of digital signatures, but the SBA requires paper copies, often with multiple copies. The SBA needs to modernize its documentation collection process to allow SBICs to communication and submit documents electronically.

SBA has attempted to update some of their data collections into an electronic format. The SBICs applaud them for their efforts, but the execution can be improved. The new Form 468 electronic system was delayed in coming on line and has been taken down to fix bugs. Once the system is complete and functional, it will provide great efficiency to SBA and to SBIC funds, but we are not there yet.

SBA staff have important regulatory duties and need the tools to perform those duties well. We would encourage the Committee to review the technical capabilities of the SBA and consider outsourcing operations or services that require technologies that SBA is not able to provide their employees themselves.

Licensing Process

The process of applying for a license and becoming a licensed SBIC varies from fund to fund. In our experience, the process took longer than we expected, but we had a change of personnel along the way so we understood and it was successful in the end. The SBA could be more transparent with applicants after the submission of the Management Assessment Questionnaire (MAQ). The time frame between the MAQ and licensing could be reduced if the SBA establishes a consistent work flow process that is transparent to the fund applying for a license. This workflow process could be improved by allowing information sharing and establishing consistent communication between the SBA and the fund. It would also benefit the fund if there was a structure in place to see the estimated time remaining to become licensed.

Dodd-Frank

The last section of my testimony focuses on the threat of double regulation (in three potential situations) as a result of the Dodd-

Frank Act. While the statute provides a limited exemption from SEC registration for SBICs that “solely” advises one or more licensed Small Business Investment Company, clarification is needed to prevent cases of double regulation.

The first issue involves “SBIC capital” counting towards the $150 million threshold. If an adviser advises SBICs and any other private funds (and the total assets under management exceed the $150 million registration threshold), then the threshold for full registration is triggered. The SEC has taken the position that registration is triggered if an adviser to an SBIC has absolutely any capital in any non-SBIC, no matter how small. Therefore, many SBIC advisers are forced to register with the SEC in spite of the SBIC exemption.

A second issue deals with fund managers that manage a licensed SBIC and a non-related Venture Capital fund. Both SBICs and Venture Capital Funds are excluded from SEC registration, but only if the manager “solely” manages these funds, and not another non-related fund. The SEC has taken the position that a manager of a Venture Capital Fund and an SBIC fund must register with the SEC if their assets under management exceeds $150 million. On their own they are exempt, but jointly they are captured in the regulatory regime.

The third issue involves the regulation of SBICs by the states. There is no explicit language in the Dodd-Frank Act that excludes SBICs from state registration. Therefore, federally licensed and regulated SBIC funds must register with multiple states and territories. A technical correction is needed to remove this unintended double regulation, leaving SBICs fully regulated by their licensing and reporting entity, the SBA. SBICs would continue to be closely regulated by the SBA, as they have for 55 years.

In closing I want to reiterate the success, the strength and my support of the SBIC program. The Agency is licensing qualified candidates through a stringent and thorough due diligence process which creates a high standard for licensees to meet before become licensed and having access to SBA leverage and thus becoming a valuable funding source to Small Business concerns and the economy at large. On behalf of all SBIC’s we applaud the efforts of the agency and its employees, while encouraging continued improvements and efficiencies as referenced herein that can streamline the process of licensing and the communication with its candidates and licensees, without lowering the important and high standard that had been set by the Agency to award an SBIC License.

Thank you for giving me the chance to share both my experience and the perspective of the SBIC industry. Please see the accompanying letter below from SBIA President Brett Palmer.

Steven Brown, President TCI and Managing General Partner Trinity Capital Fund II (TCF)

Biography - Steve Brown brings 28 years of lending, investment and leasing experience to TCF. Prior to starting TCF, he was a General Partner with Point Financial Capital Partners, which

managed a Venture Leasing Fund and he led both originations and lease financing efforts for all early stage lease finance at Point. Prior to Point he served as the President and CFO of InvestLinc Financial Services, which was an early-stage Private Equity Fund Manager and Business Consulting Firm. Prior to InvestLinc, he was a partner in Cornerstone Equity Partners, a private equity fund manager, and was co-founder/manager of Cornerstone Fund I, a private equity fund based in Phoenix, Arizona. In addition, Steve has worked with private investment companies and banking institutions in both real estate and commercial lending and investment roles. He has served on the board of directors of numerous operating companies. Mr. Brown holds a B.S. degree from McNeese State University in Business Administration and Marketing.

SBIA
SMALL BUSINESS
INVESTOR ALLIANCE

July 25, 2013

Rep. David Schweikert, Chairman
Subcommittee on Investigations,
Oversight and Regulations
House Small Business Committee
2361 Rayburn House Office Building
Washington, DC 20515

Rep Yvette Clarke, Ranking Member
Subcommittee on Investigations,
Oversight and Regulations
House Small Business Committee
2361 Rayburn House Office Bldg.
Washington, DC 20515

Dear Chairman Schweikert and Ranking Member Clarke,

Thank you for holding this hearing on the Small Business Investment Company (SBIC) debenture program. The purpose of this letter is to provide a brief overview of the state of the SBIC program to augment the testimony of Steven Brown.

The SBIA is the trade association representing lower middle market private equity funds, the funds investing in domestic small businesses. We count nearly all actively investing SBIC funds as members. The SBIA promotes a healthy and competitive lower middle market for small business investing. We support the SBIC program because it fills a critical market need in a way that aligns market forces with good public policy. If not for the SBIC program, thousands of good businesses would not be able to access growth capital.

The SBIC program has grown and improved dramatically over the past several years. Real improvements have been implemented by SBA and great credit is owed to the team that has managed this change. Processes are often faster and there is a greater diversity in fund managers. There are more licensed SBIC debenture funds than ever before and, because of the SBA's high licensing standards, they have been excellent stewards of the taxpayers' trust. These successes and improvements are profound and noteworthy. Our suggestions for improvements should not detract from the major accomplishments that have already been implemented. These suggestions are offered in hopes that SBA can use them to build upon their successes.

Standard Operating Procedures

The Standard Operating Procedures (SOP) that guide the operations of the program are overdue for modernization. The SOP does not reflect the real policies and procedures that are in place. Both the SBA and the SBICs would benefit from a SOP that reflects the reality of what the SBA is doing and is going to do. We would also suggest that the SBA put out any proposed changes for comment so that changes made are fully considered for maximum effectiveness.

Technology

SBA's Office of the Chief Information Officer has not adequately supported the Investment Division with the tools needed to efficiently perform their duties. The technology resources for the SBA are woefully inadequate and hinder the ability of the SBA to operate effectively.

The email system is so limited that emails with documents attached often cannot get through to SBA staff. This limitation forces documents to be mailed in, often in duplicate, and the mail room at the SBA can often be a black hole or at least a time machine – documents disappear or reappear weeks after being mailed in. Many applicants now have their documents hand delivered to the SBA. The private sector uses data rooms and other basic technology to manage information. SBA would benefit, both from cost savings and time savings, from using basic, readily available information sharing and workflow technologies.

One of the most promising improvements to SBA's technology has also been one of the more frustrating. SBA is moving to a web based data collection system for the Form 468. Once operational this will significantly save time and resources for both SBICs and for the SBA. However, the rollout of the new system has had serious problems. We have lost count on how many false starts and moved deadlines that have surrounded the implementation of the new system. The goal is laudible, but the execution has been disruptive and time consuming. The Investment Division has struggled to get the basic computer resources to execute the new system. Once the system works it will be a major improvement, but we are not there yet. We would encourage the SBA Chief Information Office to better support this and other improvements being made by the Investment Division.

It has been over a decade since laws were changed to require the acceptance of digital signatures, but the SBA requires paper copies and physical signatures, often with multiple copies. The SBA should modernize its documentation collection process and policies to allow SBICs to communicate and submit documents electronically with digital signatures.

Licensing

The process of licensing new and returning SBICs is instrumental to getting capital into the hands of small businesses. It is also one of the most critical taxpayer protections. The licensing process has seen major improvements that are now bearing fruit. This may be the biggest area of improvement at the SBA over the past several years. Licensing is faster and there is a greater diversity among fund managers. Licensing times, particularly for repeat licensees, have dramatically reduced. It should be noted that the Agency Committee has made their meetings a much more regular occurrence which has been one of the reasons that licensing has successfully reduced processing times.

Even with the current licensing improvements, this process deserves review and further improvement. In addition to the technology improvements previously mentioned, the licensing process should have more transparency and fairness to applicants. Some of the general problems that are brought to the attention to the SBIA include: duplication of processes; unwritten rules or

non-public standards and processes; lack of consistency; and lack of clarity on standards. All of these concerns have seen improvement over the past several years. However, many, if not most, of these continuing issues are caused by the structure of the Agency Committee.

The core structural problem with the Agency Committee is that is largely composed of SBA senior staff whose primary daily duties are and expertise may not be directly applicable to private equity. They are accomplished and smart professionals, but that does not mean their particular expertise adds value to this particular fund vetting process or protections to the taxpayer. SBIA supports strong fiduciary standards and a rigorous vetting processes, but the Agency Committee is not structured to provide the best of either. The Agency Committee should be restructured or replaced with experts specialized in vetting private equity funds.

The licensing process has many stages with the deepest, most detailed reviews by staff who are specialized in vetting private equity coming in the first several stages. They are quite good at their jobs, even if overworked and under resourced. Despite the efforts of the licensing teams and multiple licensing committees, there are uncommon occasions where funds are rejected at the Agency Committee. These rejections are sometimes based on issues that were never raised previously in the process by the SBA and where the applicant is not given a chance to address the issue. It is unfair to blindside an applicant team that has spent hundreds of thousands of dollars and years of their lives working through the process. If new, negative evidence arises at the 11th hour, then raising it at the Agency Committee would be appropriate. But what we have occasionally seen are rejections based on new interpretations of disclosures that were openly submitted and accepted previously with an affirmative vote from both the Investment and Divisional Licensing Committees. Sometimes the issues raised at Agency, that may effectively terminate the application, are completely new to the applicant or are based on issues not in the record. The Agency Committee should be structured to have clear standards that are consistent throughout the entire process and communicated to the licensing teams and committees. Applicants should be given a fair chance to address any and all issues raised at any stage of the application process.

Further, the SBIA believes that it is inappropriate that the General Counsel gets two votes on the Agency Committee – effectively a veto. It is important to note that by the time the Agency Committee meets to act on an SBIC applicant the legal documents have already been reviewed and approved by the SBA lawyers and the applicants have passed an intensive vetting on the particulars of the applicant fund. Is it ever reasonable to expect that a deputy counsel would vote against his or her boss, the General Counsel, in a committee vote? No. This bloc voting structure is not justified, particularly by lawyers on issues they have already reviewed and approved. If the General Counsel is on the Agency Committee then she or he should have only one vote, just like the rest of the Committee members.

It is worth noting that the Agency Committee structure does not appear to encourage decisions based exclusively on facts in the record, to provide clear guidance for their rejections, or provide for any type of appellate process. Some rejected funds can recover and get an additional review from the Committee, but for some applicants it is a surprise end of the line. If not for the fact that there is such a professional stigma to being rejected for a license, the SBA would be sued for denial of due process and would be forced to fix their due process deficiencies.

The SBIC program is an excellent program that should be viewed as an example of good public policy. We appreciate the hard work and professionalism of the SBA, from the most senior appointments to the most junior staff. Because of their commitment this program works to benefit thousands of small businesses and tens of thousands of employees.

Thank you for your focus on the SBIC program.

Sincerely,

Brett Palmer
President

Testimony of John J. Sherman

Founder, Director and Former CEO, Inergy, L.P.

Before the United States House of Representatives

House Committee on Small Business

July 25, 2013

Good morning. My name is John Sherman and I am from Kansas City, Missouri, near the congressional district of full committee Chairman Sam Graves. I am an entrepreneur who has been fortunate enough to launch and successfully grow and develop two companies from scratch. I am here today because I have been asked to share with you my experience with the SBIC program while building Inergy, L.P., an energy infrastructure company.

Three partners and I launched Inergy in 1998. We were seasoned professionals in the propane industry; and through our experience, we thought that we could build a successful enterprise in the sector. There were approximately 5,000 independent propane retailers across the U.S. Many of the owners of these businesses were at or nearing retirement age, often without family members prepared to take over the business. We believed we could build a scalable business.

Our strategy was simple:

- acquire local and regional propane operators with excellent customer service and safety records;
- grow the business rapidly, both through acquisition and organic expansion;
- access the public capital markets using a Master Limited Partnership (MLP structure) to ensure our ability to grow; and
- ultimately diversify into the broader energy sector.

We funded the start-up with $600,000 of our own money and raised $900,000 of equity from the seller of our original acquisition prospect. We went to several banks that turned us down for additional funds but eventually obtained an additional $4.5 million acquisition loan. The bank loan was with a local Kansas City bank, had strict covenants, and was personally guaranteed by us and our spouses.

With a goal of ultimately going public, we recognized that we would need private equity to serve as a bridge to an eventual IPO. We also recognized that—in addition to gaining capital—we needed the expertise that comes with institutional capital and the business discipline that must go along with it. We were business operators, not financial professionals; and we recognized that we needed access to expertise to help us get to that next level. So we talked with a number of private equity and mezzanine financing firms.

We ultimately connected with an SBIC, Kansas City Equity Partners (KCEP); and on December 31, 1999, we signed an agreement with KCEP for Inergy's first private equity investment, KCEP purchased a $2 million preferred interest in our fledgling company.

It is important to point out that KCEP took the time to get to know us. They recognized that we had deep expertise in the propane industry, our business plan was solid, and the founders were at risk. Plus, KCEP was flexible as to our financial structure; and they were not asking for control, which was important to us.

We used that initial $2 million investment to acquire a number of small, independent propane operations over the ensuing months. We also benefitted from the partnership with this SBIC as they helped us zero in on what it would take to access public capital markets.

By January 2001, we had identified a significant potential transaction—Hoosier Propane located in Indiana—that would provide the critical mass necessary for us to take Inergy public. We secured bank financing and obtained $7.4 million in equity from the sellers. The sellers also carried back a $5 million loan, but that left a gap of $16.5 million.

A group of private equity investors led by Kansas City Equity Partners purchased a $16.5 million preferred interest in Inergy as the anchor investment. All members of the group were qualified as Small Business Investment Companies (SBICs). The other SBICs included Mid States Capital, Invest America, Kansas Venture Partners, Rocky Mountain Capital, Diamond States Capital, and Southwest Partners.

That $16.5 million was the key piece of capital that allowed us to make a strategic acquisition. Very shortly after we closed that transaction, we filed the paperwork for the IPO process. Just seven months later, in July 2001, Inergy went public. We continued to grow the company dramatically after that, completing more than 75 retail propane acquisitions, becoming the third largest propane company in the country, and employing nearly 3,000 people.

Over the years, we diversified Inergy into the midstream energy sector; and today the company is recognized as a major developer and operator of U.S. energy infrastructure including storage, pipelines, and logistics assets. In May, we announced a merger with Crestwood Midstream Partners, which will create a $7.5 billion midstream energy company that is extremely well positioned to leverage the growing importance of the emerging shale plays around the country. The combined company will continue to create even more jobs and invest large amounts of capital in energy infrastructure across the United States.

We could not have done any of that without the initial investments we received from the SBICs. Although we have raised billions in capital over the years, no investment was more valuable to us than the SBIC capital we raised that allowed us to reach critical mass and take Inergy public.

Thank you for the opportunity to share the Inergy story.

Statement of the U.S. Chamber of Commerce

ON: "Examining the Small Business Investment Company Program"

TO: The House Committee on Small Business, Subcommittee on Investigations, Oversight and Regulations

BY: Philip Alexander, CEO of Brandmuscle, on behalf of the U.S. Chamber of Commerce

DATE: Thursday, July 25, 2013

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Statement on

"Examining the Small Business Investment Company Program"

Submitted to

THE HOUSE COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

on behalf of the

U.S. CHAMBER OF COMMERCE

By

Philip Alexander, CEO of Brandmuscle

Cleveland, Ohio

July 25, 2013

Chairman Schweikert, Ranking Member Clarke and distinguished members of the Subcommittee, thank you for inviting me to testify before you today on the Small Business Administration's (SBA) Small Business Investment Company (SBIC) program and its impact on the ability of U.S. businesses and entrepreneurs to compete, innovate and create jobs. I commend your efforts in holding this important hearing to better understand the SBIC program and the critical role it has played in the success and growth of my business.

I am Philip Alexander, President and CEO of Brandmuscle, a recently SBIC funded small business that is currently headquartered in Chicago, with offices in Cleveland, Austin and Los Angeles. I am here to speak with you today, not only as CEO of Brandmuscle, but also on behalf of the U.S. Chamber of Commerce.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector, and region. More than 96 percent of the Chamber's members are small business with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. Therefore, the Chamber is particularly cognizant of the problems of smaller businesses, as well as the issues facing the business community at large.

I came to the United States over thirty years ago with little more than the determination to obtain a first class education. After obtaining an MBA degree at Case Western Reserve University, in Cleveland, Ohio, I pursued a career in marketing and quickly ascended to senior positions with national and international retailers,

serving as vice president of brand management for Pearle Vision as well as vice president of marketing for Western Auto, a subsidiary of Sears, Roebuck and Co.

Although very successful within the corporate world, I always knew my entrepreneurial spirit would lead me to even greater opportunities should I strike out on my own. In 2000, I left the comfort and security of my company job and Brandmuscle was born. It was a solution to a common problem within the marketing industry that had challenged me for y ears; how do you roll out a national marketing campaign relevant to potential consumers within local markets and diverse communities? For a national company, building consistent brand equity across all markets is extremely important, yet many local perceptions influenced the purchasing decision.

There are close similarities in politics that parallel this marketing dilemma. Former Speaker of the U.S. House Tip O'Neill coined the phrase, "All politics is local." This axiom encapsulates the principle that your success is directly tied to your ability to understand and influence the issues of local constituents or communities. As you know only too clearly, attempting to communicate to the varying interests within a congressional district is a challenge, and trying to broaden a message and outreach nationally can be extremely daunting, especially when control of that message is distributed to many well-intentioned supporters throughout the country.

Brandmuscle was launched as a powerful solution to unleash a company's brand where the buying decisions are made—in the local marketplace. Our local marketing software enables companies to empower their network of local distributors, dealers, franchisees and salespeople with everything they need to deliver brand-approved marketing tactics customized to local needs, tastes and other relevant differences that can affect the sale.

Today, Brandmuscle, has reinvested the local market place and evolved into a world class suite of marketing services and solutions. We are proud to have as clients some of the most well-known corporate Fortune 500 companies. Some of our current products and services include the following:

1. BrandBuilder® allows a company to customize and execute local marketing campaigns with legally compliant advertising for virtually any type of media on our local marketing platform and ad builder.

2. Design Tracker® allows a company to efficiently manage local marketing and in-house graphics activity. A large percentage of on-and-off premise marketing materials are designed and produced locally by distributors or branches. This business workflow typically has a lack of cost controls, minimal compliance with branding guidelines, and inferior production capability.

3. Display Tracker™ a web-based solution that allows distributors to create customized Point-of-Sale (POS) materials at the retail level. The application uses Variable Data Print tech-

nology to add personal messages and account names to POS material that is kitted for retailer distribution. This provides a dramatic reduction in per unit pricing of POS material to more closely assimilate long run print pricing.

Since its launch, Brandmuscle has been honored to receive numerous awards in recognition of our involvement with the community and our business integrity:

- 2012 Medical Mutual Pillar Share Award, Community Service
- 2012 Crain's Cleveland Business Leading EDGE Award, Entrepreneurs EDGE
- 2011 Best Internship Program Award Finalist, Northeast Ohio Software Association
- 2011 Richard Shatten Civic Distinction Award, Entrepreneurs EDGE
- 2010 Weatherhead 100 Award, Council of Smaller Enterprises (COSE)
- 2010 Crain's Leading EDGE Award, Entrepreneurs EDGE
- 2009 Crain's Cleveland Business Leading EDGE Award, Entrepreneurs EDGE
- 2002 Innovation in Business Award, Smart Business Network Magazine
- 2002 Philip Alexander named "Visionary", 4th Annual SBN Innovation in Business Conference

Today, Brandmuscle employs over 550 well-paid professionals in the United States, many of whom are still located in downtown Cleveland, Ohio, where the company was started. Given Brandmuscle's quick rise to success, it is easy to overlook important factors that brought the company to this level. Like many small business owners across the nation with a great idea and limited resources, 'pulling yourself up by your own bootstraps' is the primary way I began my journey to achieve the American dream.

With limited resources and no staff, convincing my first corporate client to purchase services from my fledgling company required almost as much innovation and marketing skills as it did to develop the product. Even though it was a memorable event when the first dollar arrived, there was little time to celebrate. Delivering on your commitments during the early stages of business development requires hiring capable employees and developing internal procedures that exceed the client's expectations. It takes extraordinary amounts of both human and financial capital to build a business. While I had confidence in my business and marketing expertise, acquiring enough resources to foster the accelerated growth needed to propel Brandmuscle to its current level of market dominance took an incredible amount of time and energy.

There is one commonly misunderstood fact; for a fast-growing, job-generating company like Brandmuscle to thrive, many diverse avenues of funding are essential. Irrespective of a company's profits, the inability to access a robust supply of external capital during critical times in the growth cycle can severely impact revenues, profit, jobs, and even the ability to survive.

For Brandmuscle, early stage funding came from savings and an early Angel. Not long afterwards, several successive infusions of "venture funds" provided the foundation to drive revenue growth to a level that would support a payroll of approximately one-hundred and fifty jobs. Under that business debt/equity structure, Brandmuscle had reached a point in which the growth rate could only comfortably add another three or four jobs a year. We had not yet reached our full potential; our existing capital structure would limit our progress.

While "angel" and "venture capital" funding had served the purpose in filling the gap between start-up financing and our current level of market maturity, different funding sources were needed to cash-out original investors and reposition us for further expansion. Brandmuscle was too small and did not have the resources to go public. Additional liquidity through venture capital funding from additional private equity placement was an expensive way to recapitalize, given our proven history of success. And we needed to do more than just recapitalize to grow—we needed additional capital, products and people.

Commercial bank debt financing is typically not available to companies with the level of investment risk required that Brandmuscle had in 2012. Since most of our assets were intangible property, convincing banks to lend based on collateralizing those assets, was not practical.

The SBAs SBIC program was unique in its ability to provide Brandmuscle with the resources for our next phase of innovation and aggressive growth within the distributed marketing landscape. This federal government program, which has zero cost to the taxpayers, allows for a SBIC fund manager to leverage up to twice the amount of their private capital in order to provide a company like Brandmuscle cost-effective, mezzanine debt financing in order to recapitalize and position us to foster more job growth.

In February of 2012, The Riverside Company, equipped with assets from their recently SBIC backed Riverside Micro-Cap Fund II, signed a purchase agreement to fully acquire Brandmuscle through a mezzanine debt restructuring arrangement. Brandmuscle had instant access to the extraordinary managerial talents and financial backing of the Riverside team, a well-respected leader in PE management.

Riverside's SBIC fund provided financial backing for the acquisition and merger of several other companies within their portfolio family providing us added opportunities. Brandmuscle was immediately able to integrate with Riverside's platform Centiv Services, a Chicago Illinois-based provider of marketing automation technology and digital print fulfillment services and TradeOne Marketing, an Austin, Texas-based trade promotion management company, to build out our distributed marketing platform. As a result of Riversides funding and counsel, in just over a year, Brandmuscle's newly acquired market strength and vertical alignment had dramatically increased income and earnings. This was not done at the expense of cutting jobs; we not only sustained our

combined level of employment, but created an additional forty-two jobs.

The Riverside Company is one of the largest and oldest global private equity firms in the nation with over $3.5 billion in assets under management. With more than twenty-five years in business, they have completed over three-hundred acquisitions and have over two-hundred people worldwide. It was welcome news when Brandmuscle was able to obtain the cost-effective, capital needed to make it to the next level. Just as important as the funding, was Riverside's commitment to nurture Brandmuscle with the goal of building it into a more effective enterprise through time-tested management techniques, organic growth and add-on acquisitions.

Chairman Schweikert and Ranking Member Clarke, without the SBAs SBIC program, a company with the talent and resources of Riverside would unlikely seen value in engaging with an enterprise the size of Brandmuscle. Their SBIC baked Micro-Cap funds represents only a fraction of their massive portfolio. I am convinced that it was the incentives that were afforded to Riverside by the SBIC program which made us an attractive candidate for their consideration.

In conclusion, from the day that I conceived the idea of Brandmuscle, to the present, obtaining sufficient capital has always been a challenge. I know firsthand that in order for a company to successfully grow, expand and create jobs, it requires the right type of capital at the right time. Seed money, start-up capital and different stages of growth capital all come at different costs, maturities and expectations. All sources of capital play a distinct and vital role in bringing a company to the next level as a business progresses through its life-cycle.

At no expense to the taxpayer, the SBAs SBIC program fills a void by providing access to capital, especially mezzanine structured debt, for fueling the growth of small businesses where alternative funding is not available in the private sector. On behalf of the U.S. Chamber of Commerce's small business membership, and myself, I strongly recommend that you retain, enhance and strengthen this critical source of capital for small businesses. To that end, I urge you to pass the bi-partisan bill, H.R. 1106, the 'Small Business Investment Company Modernization Act of 2013' into law.

I thank you for inviting me to testify and look forward to answering any questions.

Congressional Testimony of Professor David T. Robinson, PhD before the Committee on Small Business Subcommittee o n Investigations, Oversight and Regulations

Ladies and Gentlemen of the Committee: Thank you for the opportunity to testify before you today. Spurring startup activity in the US is central for promoting economic growth more broadly and I am grateful for the opportunity to speak before you on this important topic.

Although economic policy in the United States tends to focus on small businesses, the best available economic data indicate that young businesses, not small ones, are responsible for the lion's share of economic growth in our country.[1] The confusion is understandable: almost all young businesses are by their very nature small, but most small businesses are not young. While small businesses are undoubtedly an essential part of the fabric of American life, most are not important engines of job creation. (If they were, they would not continue to stay small.) Young businesses are a different story: most fail, but the ones that succeed create jobs and increase our country's economic dynamism.

In this regard, the early-stage SBIC initiative is laudable both in terms of its objective and in terms of its creativity. I would like, however, to draw your attention to three facts about early stage business activity that, taken together, should temper our expectations of policies that attempt to stimulate early-stage business activity by extending leverage to equity investors in this market.

First, my work with Alicia Robb of the Kauffman Foundation shows that debt, not equity, is the primary source of capital for new businesses.[2] While we have long understood that credit markets were important for small business, it is surprising that NEW businesses rely so heavily on the banking sector for access to capital.[3] This is true for a wide range of startups: even high-tech, Venture Capital-backed firms rely heavily on access to bank debt through credit lines, personal and business bank loans.

Because home equity is such an important source of collateral for most individuals at the prime age for starting new businesses, this means that the collapse of the housing market was as much a crisis in entrepreneurship as it was a crisis for the banking system.[4]

The second fact is that early stage investing is extremely risky. Failure occurs often. Successes are rare, but are highly rewarded. For every Goggle or Apple, there are thousands of bad ideas that never make it out of the inventor's garage. There is an understandable need to create curbs inhibiting excessive risk-taking and dis-

[1] See John Haltiwanger, Ron Jarmin and Javier Miranda (2010) "Who Creates Jobs? Small vs. Large vs. Young," NBER Working Paper 16300, or Ronnie Chatterji "Why Washington Has it Wrong on Small Business," Wall Street Journal, November 12, 2012.

[2] Alicia Robb and David T. Robinson (2013) "The Capital Structure Decisions of Startup Firms," Review of Financial Studies.

[3] See also Alan Berger and Greg Udell (1998) "The Economics of Small Business Finance: The Roles of Private Equity and Debt Markets in the Financial Growth Cycle," *Journal of Banking and Finance* 22:613–73.

[4] Evidence connecting home equity to startup activity can be found in Manuel Adelino, Antoinette Schoar and Felipe Severino (2013) "Housing Prices, Collateral and Self-Employment," working paper, Duke University.

couraging bad investment performance, such as the provisions that are included in the early-stage SBIC guidelines. We must nevertheless be aware of the fact that these provisions are likely to discourage some of the most desirable investments from being undertaken: these are the speculative investments that are sometimes associated with the most disruptive technological innovations.

The third fact that bears consideration is that the gestation periods for many early stage investments are prohibitively lengthy for many investors. Increasing the flow of capital into the sector will not change the waiting time between the first investment and the acquisition or IPO that will provide the return to the early-stage investor. The primary remedy here is increased liquidity in later-stage investment markets. Some of the most interesting features of the JOBS Act passed last spring are those features that stimulate the development of intermediate liquidity opportunities for early stage investors.

These three facts conspire to make your job a difficult one. To put it simply, we are swimming against the current when we attempt to stimulate early stage investment activity by leveraging existing equity in the sector.

Given these facts, what is the underlying economic mechanism that will likely be responsible for the successes that we do see?

In my view, it is this:

Investors without sufficiently deep pockets are often discouraged from making speculative early-stage investments because they are worried that their early investments will become diluted by later-stage investors. It's not that they need capital to make more investments now; they need more capital later to be used when follow-on investments occur. In my view, the key to this program's success will lie in its ability to amplify the amount of "dry powder" that early stage investors have on hand to participate in later-stage funding rounds as successful investments grow to fruition. Giving early-stage investors the confidence that they will have access to sufficient capital to take their investments across the finish line will be the hallmark of this program's success.

Thank you.

House Committee on Small Business

Subcommittee on Investigations, Oversight and Regulations

Hearing July 25, 2013

"Examining the Small Business Investment Company Program"

Questions for the Record

Question: During your testimony, you mentioned that a Standard Operating Procedure (SOP) which looks at alternative ways of licensing applicants is currently in the agency's clearance process. This SOP is considered an interpretive regulation of a broader regulation, and as such, is covered under the agency's responsibility to perform a retrospective review pursuant to Executive Order (E.O.) 13563. Did SBA comply with E.O. 13563 and reach out to the small business community in its review of the licensing process? If so, what feedback did the agency receive? If not, why wasn't this process followed?

SBA Response

SOP 10 04 provides internal guidance to personnel engaged in the processing of SBIC license applications to ensure that those processes are consistent with statutory and regulatory requirements. The draft SOP 10 04 is the result of an ongoing effort by SBA's Office of Investment and Innovation (OII) to improve SBIC licensing procedures. It memorializes OII's streamlined processes and reflects current operational practices as well as input received over the past several years.

In compliance with Executive Order (E.O.) 13563, since FY 2009, OII has reviewed industry best practices and worked with applicants and stakeholders to identify improvements to our licensing procedures. The SBIC industry provided valuable feedback regarding processing times, "green light letter" expiration, and electronic-based licensing. As a result, we have decreased average licensing times by 54 percent and extended the green light letter expiration period from 12 to 18 months. As I indicated at the hearing, OII is actively pursuing technological improvements for SBIC reporting as well as its other processes, subject to budget constraints. It is important to note that SOP 10 04 will not preclude the adoption of technology as it becomes available.

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON SMALL BUSINESS

SUBCOMMITTEE ON INVESTIGATIONS, OVERSIGHT AND REGULATIONS

HEARING:

EXAMINING THE SMALL BUSINESS INVESTMENT COMPANY PROGRAM

TESTIMONY:

JOSE E. FERNANDEZ-BJERG

CHAIRMAN AND CEO, OMEGA OVERSEAS INVESTMENT CORP.

JULY 25, 2013

Dear Chairman Schweikert, Ranking Member Clarke and subcommittee members, thank you for allowing me to provide testimony on the Small Business Administration's Small Business Investment Company Program ("SBIC"), particularly on whether the SBIC program is meeting the capital needs of small business owners.

My name is José Enrique Fernández-Bjerg. I am the Chief Executive Officer of Omega Overseas Investment Corp., a private international banking institution. I am also a member of the Board of Directors of the Government Development Bank for the Commonwealth of Puerto Rico, and have served as a member of the Board of Directors of the Federal Home Loan Bank of New York.

During my 40-year career in banking and finance, I have been involved in thousands of financial transactions, including managing the operations of Prudential Bache, Paribas, AG Becker and Drexel Burnham Lambert. From 1988 to 2004, I led Oriental Bank & Trust which evolved into Oriental Financial Group (NYSE: OFG), a firm that manages over $10 billion in assets; currently the second largest local bank in Puerto Rico. In 2005, I founded Omega as the first multi-sector institutional investment firm on the island. Omega's largest asset class is private equity and our international firm manages investments in the United States and over 50 countries. My 25 years of private equity experience includes my participation, since 1994, as a member of the Investment Committee of the University of Notre Dame. As a Trustee of the University, we oversee $8 billion of assets under management and over $2.5 billion in private equity holdings. The portfolio we have managed has been ranked among the top 10-performing portfolios in the country for the last two decades.

I testify before this honorable subcommittee today to share my concern for the state of the investment ecosystem in several Low and Moderate Income jurisdictions of the United States, which lack adequate access to capital vehicles for small business owners. I would also like to share recommendations on how that ecosystem could be improved.

Background on SBICs in Low and Moderate Income markets

As stated by the SBA, the SBIC mission statement is "...to improve and stimulate the national economy and small businesses by **stimulating and supplementing the flow of private equity capital** and long term loan funds for the sound financing, growth, expansion and modernization of small business operations while insuring the maximum participation of private financing sources."

The SBIC has historically being instrumental in achieving that mission. Nonetheless, that mission has been concentrated in certain parts of the Nation, such as New York, California, Chicago and Massachusetts [1], while other parts of the country still face immense shortages of private equity capital. **For instance, while the number of SBIC licenses has increased slightly (from 299 in 2011 to 301 in 2012), during that same period businesses located in Low and Moderate Income areas financed by SBICs has dropped by over 38% (from 321 in 2011 to 216 in 2012) [2].**

While the causes for such a discrepancy may be multiple, it seems indisputable that the current licensees are not focusing on growing their portfolio of investments in Low and Moderate Income markets. That fact exacerbates and perpetuates a vicious cycle by which small businesses located in Low and Moderate Income markets are not able to grow due to limited capital options, and therefore stay at a size below their potential, or in the more unfortunate cases, fail when they lack capital to expand and compete with better financed competitors. That is precisely the type of system failure that a program such as the SBIC is intended to address, and that we hope it can remedy.

This testimony will summarize our analysis of the SBIC program's current limitations. The conclusion of our yearlong study is that **investors in many Low and Moderate Income regions have little chance of receiving an SBIC license under the current program structure.** However, we believe that there is an opportunity to correct this imbalance and implement program changes that can have a dramatic impact on the economic development of economically disadvantaged zones.

Evolution of the Private Equity Ecosystem & the SBIC Program

[1] See SBIC Annual Report, Fiscal Year 2012, page 17.

[2] Please note that this dramatic drop might be partially explained by the number of participating securities SBICs.

During the 70's the United States pioneered the private equity industry, with its geographic concentration near major financial centers or technological centers. In these regions the evolution of the private ecosystems is usually world class and self-funded from private sources. Thanks to the SBIC program, in the 90's the private equity industry was able to expand to less-developed surrounding cities/states, and the SBIC program provided much needed capital to the next generation of fund managers.

By the turn of the century the SBIC program continued to evolve and began to implement more professional private equity industry practices, which began to outpace the economic development of disadvantage zones. At a recent SBIC conference we heard from a successful fund manager that under the new regulations "I would have never received the license that I was awarded in 1999."

The most recent financial crisis caused the SBIC to increase restrictions based on private equity performance best practices. While necessary, the unintended consequence of those new restrictions was that it is not almost impossible to find a universe of managers that fit the SBIC licensing specifications in many Low and Moderate Income markets.

Our task force has met with SBIC experts in Washington DC to discuss this issue. They concur with our conclusion that obtaining a license in Low and Moderate Income markets that lack a PE ecosystem is extremely difficult. The key reason is that Low and Moderate Income regions do not have developed private equity industries or professionals with enough direct experience to qualify for a license.

SBA's Actions to address capital shortages in Low and Moderate Income markets

The SBA recognizes that small businesses in Low and Moderate Income markets suffer from inadequate access to capital, and has taken recent steps towards remedying that deficiency. In particular, as part of the Start-up America initiative, the SBA created the Impact Investment SBIC program (hereinafter, the "Impact Program"), for the purpose of providing access to capital to small businesses located in rural areas or employing residents of Low and Moderate Income or economically distressed areas.

Based on the most recent Annual Report from the Office of Investments[3] only two Impact licenses had been issued. While part of the limited number of Impact licensees may be due to its relatively recent creation, we have analyzed its requirements and believe the way the licensing process is been implemented may be putting insurmountable obstacles to its long-term success. For instance, per the SBA, "Impact Investment SBIC applicants must submit the same documents, follow the same process, and meet the same high standards as any applicant to the SBIC program"[4] In

[3] Ibid., page 19.

[4] SBA's Memorandum on "Start-Up America Impact Investment SBIC Initiative Policy Update" Dated September 26, 2012. https://docs.google.com/viewer?url=http://www.sba.gov/sites/default/files/files/External%25201mpact%2520Memo%25202012-09-26%2520final.pdf

fact, based on our analysis of the application process, the Impact License has very few advantages over the regular license, while it imposes more restrictions. Paraphrasing a senior SBA manager, applying for an Impact License "may save you a couple of months in the evaluation process, but it won't be evaluated any differently than a regular license".

SOP limitations to an expanded Impact License Program

For an applicant in a LMI area, some SBA requirements make the approval of an SBIC license quite difficult. For instance, the track record requirement, as stated by the SBIC program, includes the following:

- "The track record contains investments that are analogous to the types of investments that are proposed for the SBIC with regard to size, stage, structure, sector, or any other key variables.
- **The track record contains a meaningful number of full, positive realizations that have been achieved within the past ten years.**
- The overall performance of the track record is strong on an absolute and relative basis **across multiple investment cycles.** (Emphasis added.)" [5]

If there is no, or a very limited, PE ecosystem in a LMI market, meeting those requirements of a ten year record, and multiple investment cycles becomes quite difficult. In addition to track record, SBA considers the broader qualifications of the applicant's fund management team, including:

- "At least two team members have track records that meet the requirements discussed above.
- The team members **have a history of working together** and form a cohesive unit. (Emphasis added.)" [6]

While in New York City, San Francisco or Boston, there is a much higher probability of applying as a team that has a history of working together, in LMI markets where deals are few and far apart, that requirement could be very difficult to attain. In essence, LMI markets are in the proverbial chicken-and-egg situation, since there are very few PE firms with a long history, and track record working together, the ability to benefit from programs such as the Impact SBIC is quite limited. But it is precisely programs such as the Impact SBIC that could allow for those funds to be created and flourish.

Finally, I would like to bring to your attention the role of the banking industry in LMI regions like Puerto Rico. Puerto Rico's local banks also have to meet the FDIC's community reinvestment regulations (CRA). In larger markets banks work and invest in SBIC funds, which in turn help them comply with CRA requirements. Unfortunately, in Puerto Rico and other LMI areas banks

[5] SBIC pre-screening instructions: http://www.sba.gov/content/pre-screening-instructions
[6] Ibid.

meet their CRA requirements through basic mortgage lending and thus feel no need to work, invest, or establish SBIC funds.

Recommendations

Our task force respectfully recommends four courses of action to address the imbalance in disadvantaged regions:

1) Conduct an investigation on the reasons why the SBIC licensing process has not been as successful in economically disadvantage zones. The analysis should have a specific focus on understanding zones that lack a private equity ecosystem. The report should provide solutions to correct this imbalance and promote small businesses and private equity fund market development.

2) Conduct a thorough review of the SOP, with the intent of easing certain SBIC Impact License requirements in economically underdeveloped regions, including:

a. Ease the need to demonstrate a significant and prolonged track record in LMIs where the existing PE ecosystem is fairly underdeveloped.

b. Ease the team requirements to allow partnerships to be created, even if they might not have worked directly in the past

3) Promote the creation of more SBICs in LMI areas by:

a. Assigning a portion of the Impact allocation, possibly via an RFP, to fund SBICs in selected underserved regions within the next 18 months.

b. Establishing a mentoring system for SBIC Impact License applicants, including training and education programs, which would allow for the creation of SBICs in underserved regions within the next 18 months.

4) The SBA should work with the FDIC to promote that local banks in places like Puerto Rico and other LMI areas invest in SBIC funds, by revising the CRA requirements in a way that would provide incentives to go beyond their current practice of solely investing in mortgages to comply.

Conclusion

While the creation of the SBIC Impact License is a step in the right direction, we respectfully suggest that its licensing process be modified to allow for the development of investment ecosystems in areas that have not benefitted from adequate access to capital. Certainly, these modifications should be developed while safeguarding the resources of the agency and of taxpayers. Nevertheless, we are confident that the current Impact License requirements could be eased to allow for the creation of new and successful SBICs with safeguards that are better suited to markets with limited PE ecosystems.

Thank you very much.